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No. 90-1918

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

On Writ of Certiorari to the Supreme Court of Iowa

REPLY BRIEF FOR PETITIONER

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PARTIES TO THE PROCEEDING

The statement provided pursuant to Rule 29.1 in Petitioner's Brief at page ii is currently accurate and requires no amendment.

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SUMMARY OF ARGUMENT

Contrary to the assertions of respondent and the United States, the Iowa taxing scheme involves discrimination against foreign commerce and does not differentiate based merely on place of incorporation. First, the use of foreign corporations to conduct foreign operations is a part of foreign commerce. Moreover, the Iowa taxing scheme differentiates in the tax treatment of dividends based at least in part on the location of the activities conducted by the dividend-paying subsidiary.

Amerada Hess Corp. v. *Director*, 490 U.S. 66 (1989), is not to the contrary. That case merely held that there can be no discrimination against commerce if the difference in treatment is based *solely* on the *nature* of the activities involved, and not at all on where they are conducted.

The possibility of using a domestic corporation to conduct foreign operations or a domestic holding company to hold the stock of petitioner's foreign subsidiaries, as suggested by respondent and the United States, cannot validate the Iowa statute. As stipulated by the parties, the use of domestic corporations to conduct foreign operations may not be permitted by particular foreign countries. If domestic corporations could be used, signficant conversion costs would be incurred. Moreover, any taxing scheme that requires such a change in structure to avoid a discriminatory tax "forecloses tax-neutral decisions" in violation of the Commerce Clause.

Respondent cannot escape accountability for its discriminatory taxing scheme merely because it is based on the federal Internal Revenue Code. The Iowa taxing statute must independently satisfy the requirements of the Constitution.

The attempt by respondent and the United States to focus on the tax burden borne by a subsidiary's "unitary income stream" is inappropriate. This Court has never tested the validity of a state taxing statute by examining the application of other taxing schemes to other entities. If such an examination were appropriate, its focus must be at the state level, where a proper comparison of tax burdens can be made. On that basis, the foreign subsidiary's income stream

bears a greater tax burden than that of a domestic subsidiary.

The Iowa statute violates the Equal Protection Clause. Respondent continues to offer no legitimate or rational explanation for why it discriminates in the taxation of subsidiary dividends. All respondent has offered to justify its discrimination is the convenience it finds in adopting the federal scheme. It presents no justification at all for the discrimination itself.

If this Court should decide the case in favor of petitioner on basic constitutional principles, the decision should be applied retroactively.

ARGUMENT

I. THE IOWA TAXING SCHEME FACIALLY DISCRIMINATES AGAINST FOREIGN COMMERCE

Both respondent and the United States argue strenuously that this case does not involve discrimination against foreign commerce. Instead, for the first time, they claim that this case involves only a difference in tax treatment based on the subsidiary's place of incorporation. This claim is unfounded.

The Iowa taxing scheme facially discriminates against foreign commerce by singling out for inclusion in a parent's tax base dividends paid by foreign subsidiaries conducting business operations in foreign countries. There is no dispute that foreign commerce comprehends foreign business operations. There should also be no dispute, for reasons made clear by the record in the instant case, that the use of a foreign corporation to conduct such operations is a part of foreign commerce.

A. The Use of a Foreign Corporation to Conduct Foreign Operations Is a Part of Foreign Commerce

Both respondent and the United States have forgotten, or have conveniently chosen to disregard, the stipulation of the parties regarding the conduct of foreign operations. As petitioner and respondent expressly agreed (Pet. App. 30a-31a, Stip. 10), domestic corporations typically do business in foreign countries through foreign subsidiaries for a variety of reasons. Those reasons include "the requirements of the local country, a better ability to limit their liability in that country, the marketing advantage of being perceived by customers as a local company, greater ease in repatriating funds, greater ease in borrowing funds locally, and ability to own property and manufacture in that country." (*Ibid*)

Notwithstanding the express recognition by stipulation that fundamental commercial considerations can, and do, dictate the use of foreign corporations to conduct foreign operations, respondent makes the flat assertion that "Kraft could do business in foreign countries through domestically incorporated subsidiaries." (Res. Br. 10) Although nothing is cited in support of this assertion, both respondent and the United States make it a major element of their case.

As the stipulation unequivocally establishes, the use of a foreign corporation can be integral to the conduct of foreign operations. Local requirements, as well as local business considerations, cause that to be true. Any attempt to isolate the foreign corporation itself from the foreign activities that it conducts is totally unwarranted. The foreign entity that engages in foreign activities is as much a part of foreign commerce as are the activities themselves.

Despite the insistence of respondent and the United States, the "structure" argument cannot remove the Commerce Clause issue from the instant case.

B. The Iowa Taxing Scheme Also Discriminates Against Foreign Operations

Taking the Iowa scheme as a whole, as the United States acknowledges must be done (*see* U.S. Br. 10, *citing*, *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64, 69 (1963)), it is apparent that Iowa does not base its taxation of dividend income *solely* on the place of incorporation. Rather, by adopting the federal tax code, Iowa has accepted a pattern of dividend taxation that is geared to *both* the place of incorporation *and* the location of activities.

The United States acknowledges this fact when it argues:

> The Iowa tax, by incorporating the federal distinctions, differentiates in its treatment of dividend income based upon the place of incorporation of the subsidiaries *and whether those subsidiaries are themselves subject to domestic taxation* (see notes 6 & 8, *supra*), not simply upon "the location of their activities" (*Amerada Hess Corp.* v. *Director*, 490 U.S. at 78).

(U.S. Br. 11) (Emphasis supplied.)

The United States thus correctly observes that the Iowa tax differentiates based upon *both* the place of incorporation of the dividend-paying subsidiaries *and* "whether those subsidiaries are themselves subject to domestic taxation." As previously pointed out (U.S. Br. 10-11; Pet. Br. 4-7), the categories of dividend-paying subsidiaries that are "themselves subject to

domestic taxation" are domestic subsidiaries (with either domestic or foreign operations), and foreign subsidiaries to the extent they conduct domestic operations. The only group of subsidiaries that is *not* "subject to domestic taxation" is that consisting of *foreign* subsidiaries engaged in *foreign* operations. Corporations satisfying both of those elements are in the disfavored group. Accordingly, even if the discrimination in the Iowa taxing scheme is not based entirely on the location of activities, it is clearly based in large part on that factor.

Both respondent and the United States cite *Amerada Hess Corp.* v. *Director*, 490 U.S. 66 (1989), for the proposition that a tax can be held to discriminate against commerce only if it differentiates based on the location of activities. However, nothing in *Amerada Hess* suggests that impermissible discrimination under the Commerce Clause can be found only when the difference in treatment at issue is based *solely* on the location of activities. *Amerada Hess* made the converse distinction. In that case, this Court declared that there could be no discrimination under the Commerce Clause where the difference in treatment there involved, between oil producers and non-producing retailers, was based *solely* on the difference in the nature of their two businesses, and not at all on the location of their activities.[1]

[1] *Amerada Hess* upheld a provision requiring the "add back" of all federal taxes on income and profits, including the windfall profits tax, in the computation of the New Jersey corporate tax base. The fact that only oil producers were subject to the windfall profits tax did not mean that requiring them to add back the tax caused an impermissible discrimination in favor of non-producing retailers, who were not subject to the tax and therefore could not add it back. The difference in treatment under New Jersey law was based solely on the difference in the two types of businesses, not on where they were conducted.

Amerada Hess does not hold that discrimination based only in part on location of activities fails to implicate the Commerce Clause.

II. THE POSSIBILITY OF USING A DOMESTIC CORPORATION OR DOMESTIC HOLDING COMPANY CANNOT VALIDATE THE IOWA STATUTE

Both respondent and the United States declare that petitioner could eliminate Iowa's discrimination by using domestic subsidiaries to conduct its various foreign operations or by forming a domestic holding company to hold the stock of its foreign subsidiaries. Neither of these alternatives, put forward for the first time in this Court, can validate the Iowa statute.

A. Use of Domestic Corporations to Conduct Foreign Operations

Once again, both respondent and the United States have either overlooked or chosen to ignore the stipulation of the parties. As there stated, foreign governments may not even permit domestic corporations to conduct business in their countries. (Pet. App. 30a-31a, Stip. 10) Thus, the blanket suggestion that petitioner could use domestic subsidiaries to conduct its wide range of foreign activities cannot be valid.

Even where it might be possible to use a domestic corporation for particular foreign operations, both respondent and the United States have completely ignored the numerous costs that would accompany any such conversion. For example, under section 367 of the Internal Revenue Code and the regulations thereunder, petitioner could well be taxed at the fed-

eral (and presumably state) level on the mere transfer of its foreign assets to a domestic subsidiary.

In any event, requiring a corporation engaged in foreign commerce to incorporate in the United States in order to avoid discriminatory taxation "forecloses tax-neutral decisions" regarding the structure and operation of its foreign activities. A taxing scheme that produces such a result impermissibly discriminates against foreign commerce. Surely, the Foreign Commerce Clause precludes state taxing schemes that induce domestic relocations of an operational or structural nature by discriminatorily taxing foreign operations conducted by foreign corporations. *Compare Westinghouse Electric Corp.* v. *Tully*, 466 U.S. 388, 406 (1984); *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 333 (1977); *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64, 72 (1963).

B. Use of a Domestic Holding Company

Apparently recognizing the weakness in their initial suggestion, both respondent and the United States suggest in the alternative that petitioner establish a domestic subsidiary holding company to escape Iowa's discriminatory tax. Presumably, the holding company would hold the stock of the foreign subsidiaries, receive dividends from them, and pass those dividends on to petitioner as domestic subsidiary dividends.

This suggestion assumes that the holding company would be located in a state that would not discriminate in taxing the foreign subsidiary dividends when first received. If, however, all states applied a taxing scheme similar to that of Iowa (as the United States recognizes is the appropriate way to test the issues here presented (U.S. Br. 18); *see also Halliburton*,

373 U.S. at 69), petitioner's foreign subsidiary dividends would be taxed when received by the holding company and nothing would be accomplished.[2]

Moreover, as noted above, any taxing scheme that requires (or even encourages) the formation of a domestic entity to avoid discriminatory taxation against foreign commerce "forecloses tax-neutral decisions" regarding the structure and conduct of multinational operations. This the Commerce Clause simply does not tolerate. *Compare Westinghouse Electric Corp.* v. *Tully*, 466 U.S. at 406; *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. at 333.

Accordingly, the suggestion to form a domestic holding company to hold petitioner's foreign subsidiary stock and receive its foreign subsidiary dividends cannot resolve the discrimination issue here presented.

III. IOWA CANNOT DEFEND ITS DISCRIMINATION BY ASSERTING THAT ITS TAXING SCHEME IS BASED ON THE FEDERAL SYSTEM

Iowa attempts to escape accountability for its discriminatory taxing scheme by asserting that since it has adopted the federal taxing statute for convenience, it need not test the validity of each provision under the Constitution.

> Also, if states have to scrutinize all IRC provisions and future amendments to determine whether they favor one type of commerce

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[2] Respondent recommends the use of a "non-Iowa" holding company. (The United States makes no such recommendation.) But, if every state had Iowa's taxing scheme, respondent's recommendation would still be futile.

> over another, it will no longer be convenient for states to couple with the IRC.

(Res. Br. 18)

Not only does the foregoing statement reflect a complete disregard for constitutional obligations, but it is also somewhat disingenuous. Iowa has had no hesitancy in selectively modifying the federal tax law to suit its own policies. For example, in 1981, Iowa's taxing statute required corporate taxpayers to make nine separate adjustments to their federal taxable income in order to determine their proper Iowa tax base. It now requires 14 such adjustments. In addition, Iowa law, unlike federal law, did not, and still does not, tax the "gross up" amount on foreign dividends or allow a credit for foreign taxes paid.[3]

Judging by its conduct and its comments, respondent appears simply not to relish the burden of ensuring that its tax law is constitutional.[4] Iowa's discrimination cannot be excused merely because the Iowa taxing statute is based in part on the federal tax code. The standard for determining the constitutionality of a state taxing scheme is not inevitably the same standard as that imposed at the federal level.

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[3] Petitioner does not intend to suggest that Iowa must grant a credit for foreign taxes paid. Under *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 at 191 n.30 (1983), such a credit may not be constitutionally required. And, in any event, it would not totally eliminate the discrimination.

[4] Interestingly, twenty-six states adopting the federal taxing scheme have found a way to eliminate the discrimination here involved. (Pet. 6-7)

IV. RESPONDENT CANNOT SAVE THE IOWA STATUTE BY ANALYZING THE TAX BURDEN ON THE "UNITARY INCOME STREAM"

Respondent also focuses on the taxation of what it calls the "unitary income stream." (Res. Br. 21) It asserts that Iowa's taxing scheme does not discriminate against foreign commerce because "[i]f every state adopted the Iowa method of taxation, the unitary earnings of domestic subsidiaries would be subject to state and United States taxation which could be more burdensome than the taxation of the foreign subsidiary earnings." (*Ibid*)[5]

In evaluating a claim of facial discrimination, this Court has refused to take into account whether any taxes were imposed by other jurisdictions on the entity claiming discrimination (such as petitioner in the instant case.) *Armco Inc.* v. *Hardesty*, 467 U.S. 638, 644-645 (1984). *See also Tyler Pipe Indus., Inc.* v. *Washington State Dep't of Revenue*, 483 U.S. 238, 242 (1987); *Freeman* v. *Hewitt*, 329 U.S. 249, 256 (1946). *A fortiori*, this Court should not take into account any taxes imposed on *other* entities (*i.e.*, petitioner's subsidiaries) in testing petitioner's claim. In addition, in undertaking such a test this Court certainly should not take into account any taxes on petitioner or any other entities imposed by other levels of government (*e.g.*, the federal government). For these reasons, the tax burden on the so-called "unitary income stream" is irrelevant and should be disregarded.

Moreover, if this Court were to undertake such an inquiry, respondent's position has no merit for two

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[5] The United States makes a similar argument. (Br. U.S. 13 n.18, 21-23)

reasons. First, at the state level, dividends and earnings fall into two distinct pools of income; they are not a unified income stream. The taxation of one of those distinct pools is not related to the taxation of the other. Second, assuming arguendo that the entire income stream should be examined as respondent suggests, a domestic subsidiary income stream would actually bear *less* of a tax burden at the state level than the foreign income stream here involved.

A. At the State Level, Dividends and Earnings are Distinct Pools of Income, Not a Unified Income Stream

For purposes of state taxation, in the absence of reporting requirements that combine parent and subsidiary incomes (*see, e.g., Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983)), a subsidiary's earnings and the dividends received by its parent constitute two distinct pools of income earned by two different entities. They are not one continuous income stream. Cf. *id.* at 191 n.30.

Iowa's apportionment of corporate income illustrates the distinct nature of earnings and dividends.[6] Iowa apportions a subsidiary's earnings based on the level of the *subsidiary's* activity in that state (subsidiary's sales in Iowa over subsidiary's total gross sales). In contrast, Iowa apportions a parent company's income, including the dividends it receives from its subsidiaries, based on the level of the *parent's* activity in that state (parent's sales in Iowa over parent's total gross sales). Thus, Iowa would tax only

[6] Iowa neither requires nor permits worldwide combined reporting. Consequently, under Iowa law, the earnings of a parent would never be combined with the earnings of its foreign subsidiaries.

10% of the earnings of a subsidiary that has 10% of its sales in Iowa. If such a subsidiary were to pay a dividend equal to 100% of its earnings to its parent doing business in Iowa, the extent to which the dividend would be subject to tax in Iowa, if at all, would be determined by reference to the extent of the *parent's* business conducted there, not the subsidiary's business conducted there. There would be no correlation, except by coincidence, between the extent to which the subsidiary's earnings were taxed by Iowa and the extent to which the dividends would be taxed at the parent level.[7]

Thus, again, any taxes imposed on underlying earnings should have no bearing on the constitutionality of the Iowa tax imposed on dividends.

B. If Income Stream Analysis is Relevant, the Foreign Income Stream Bears a Heavier Overall Tax Burden at the State Level Than Does the Domestic Income Stream

If this Court were to determine that Iowa's taxation of a subsidiary's "unitary income stream" is relevant to the issue here presented, Iowa's taxing statute is nevertheless unconstitutional because the income stream of a foreign subsidiary operating abroad is subjected to a heavier state tax burden than that of a domestic subsidiary doing business at home. As the United States recognizes, the state tax burden on a subsidiary's income stream must be measured by assuming that all states have adopted Iowa's challenged taxing statute. ("To determine whether Iowa's tax is *facially* discriminatory, however, it is relevant to ob-

[7] In the federal context, the notion of an "income stream" might be more appropriate because of the absence of separate apportionment at the parent and subsidiary levels.

serve how foreign and domestic commerce would fare if the Iowa scheme were applied by all States." (U.S. Br. 13 n.18) (Emphasis in original) *See also Armco Inc.* v. *Hardesty*, 467 U.S. at 644-645; *Tyler Pipe*, 483 U.S. at 247-248; *Halliburton*, 373 U.S. at 72.

What the United States fails to comprehend, however, is that it is also relevant (and thus necessary) in the foreign context to assume that all other comparable taxing jurisdictions (here, those in the foreign countries where petitioner's subsidiaries operate) would also apply Iowa's scheme. Otherwise the comparison would be meaningless.

Under a proper analysis, it is clear that the underlying earnings of *both* the domestic subsidiaries and the foreign subsidiaries would be fully taxed. Yet, Iowa would exclude only domestic subsidiary dividends from the parent's tax base. Thus, if adopted everywhere, Iowa's taxing scheme would systematically expose the foreign subsidiary's income stream to an additional tax burden to which the domestic subsidiary's income stream would not be exposed. For that reason, the Iowa scheme impermissibly burdens foreign commerce.[8]

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[8] In fact, the record in the instant case shows that petitioner's income from foreign subsidiaries operating abroad actually was burdened with three levels of tax—a foreign tax on underlying subsidiary earnings, a foreign withholding tax on the dividends when paid, and an Iowa tax on the dividends when received. (Pet. App. 2a, 12a) In contrast, as respondent recognizes, domestic subsidiary income from domestic operations would, at most, only be taxed twice—once at the federal level and once at the state level. (Res. Br. 21)

V. THE IOWA STATUTE VIOLATES THE EQUAL PROTECTION CLAUSE

If this Court somehow agrees with respondent and the United States that the Iowa taxing scheme discriminates based *solely* on place of incorporation, and that place of incorporation does not constitute commerce on the record here presented, such discrimination nevertheless represents a clear violation of the Equal Protection Clause.

The basis for the difference in the federal tax treatment of subsidiary dividends is the fact that the federal government has chosen to allow dividend relief in those cases where it is able to tax underlying subsidiary earnings. That may be a perfectly permissible ground for differentiation in the tax treatment of dividends at the federal level.

At the state level, however, the focus must be different. Iowa justifies its adoption of the federal scheme on grounds of taxpayer and administrative convenience, which it claims is a legitimate and rational state purpose. But the question for Iowa is, having selectively adopted the federal scheme as its own, what justification can Iowa offer for differentiating in the treatment of subsidiary dividends based on place of incorporation?[9]

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[9] The United States recognizes the point but merely says:

> The different treatment of dividends received from foreign-incorporated subsidiaries, as compared to those from domestic-incorporated subsidiaries, serves legitimate, rational state purposes. *See* Pet. App. 9a-10a; pages 9-23, *supra*.

(U.S. Br. 23)

All Iowa has offered to justify its discrimination is *the convenience it finds in adopting the federal scheme.* But convenience in adopting statutory language is not a legitimate and rational reason for singling out for taxation dividends paid by foreign subsidiaries conducting foreign operations.

VI. RETROACTIVITY

Respondent argues that, in the event its taxing scheme is held to be unconstitutional, this Court should expressly reserve the question of retroactivity for the Iowa courts to consider on remand. Petitioner sees no basis for such a reservation with respect to the issue here presented.

Invoking the doctrine of prospective application declared in *Chevron Oil* v. *Huson*, 404 U.S. 97 (1971), would not be appropriate here. A decision of this Court striking down the Iowa tax on foreign subsidiary dividends would involve no overruling of precedent and would break no new ground. While the issue is one of first impression, its resolution would have been clearly foreshadowed by such existing precedent as *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), and *Hale* v. *Bimco Trading, Inc.*, 306 U.S. 375 (1939), both of which struck down statutes that facially discriminated against foreign commerce.

A decision for petitioner would surely represent an application of settled principles to the circumstances here presented. As a result, there would be no need for this Court to reserve on the question of retroactive application in the instant case.

Respondent attempts to cloud the issue by referring to its agreement with petitioner under which respondent committed to apply the decision retroactively as to petitioner if this Court invalidated the statute. Respondent now claims that this Court's decision in *James B. Beam Distilling Co.* v. *Georgia*, 111 S.Ct. 2439 (1991), which rejected the doctrine of selective prospectivity on the facts there presented, somehow may throw the validity of its agreement into question.

Respondent ignores the fact that the agreement deals with remedies, not choice of law. The agreement simply commits respondent to the adoption of a particular remedy should petitioner prevail in the instant case. The agreement in no way relates to the choice of law issue raised by respondent. Nothing in *Beam* even bears on the question of remedies. *Beam* reiterates the rule that remedies are entirely a matter of state law.

Respondent's sudden suggestion of unwillingness to adhere to its agreement because of *Beam* is unconscionable. But it affords no basis for this Court to deny or delay the retroactive application of a decision that may be favorable to petitioner on basic constitutional principles.

CONCLUSION

For all of the foregoing reasons, the decision of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

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